

Prepayment of Royalty

Marty Grieshaber walked the participants through the first draft of the prepayment rule. These minutes present the issues discussed under the major sections of this draft rule, including any decision reached regarding those issues.

§204.101 Who may obtain approval to prepay royalties under this subpart?

Issue There were two similar issues under this section: (1) Is it necessary for all lessees to agree to the prepayment or in other words, will we allow one lessee to prepay while all others continue monthly reporting, and; on a related note, (2) should a prepayment for a qualifying marginal agreement cover the entire agreement and not just one lease or lessee in that agreement.

Discussion Industry expressed concerns that it will be difficult to obtain agreement from all lessees. This problem increases exponentially as they have to prepay an entire agreement because the number of lessees increases greatly. MMS believed that allowing a single lessee to prepay their portion of royalties will create accounting (AFS/PAAS comparison) problems because a portion of a property will be prepaid while other portions are not.

Resolution No consensus was reached. This is a policy decision that will be made by MMS management.

§204.102 How do you request to prepay your royalties?

Issue What happens if all lessees agree to prepay but each (or more than one) lessee wants to prepay individually?

Discussion Industry was concerned that even if all lessees agree to prepay, they may want the option to submit their own prepayment. The rule is currently written to accept one prepayment application per marginal property. We may have to rewrite this section to encompass more than one application per property depending on the decision of this issue.

Decision No decision was reached although no MMS personnel objected to the concept of more than one prepayment application for the same property. We will raise this issue internally to identify potential problems. If none exist, we will rewrite this section.

Issue What information will be submitted with the prepayment application?

Discussion The draft rule asked for the actual prepayment calculation including a laundry list of minimum needed items. There was some objection from industry that why do we need anything more than the prepayment amount, equating this to when they bid on or sell an oil and gas property. The solicitor explained that the law allows our discretion to require any information we deem necessary to calculate royalties, and hence, the prepayment. We also explained that their actual calculation may be needed to resolve any differences between their and our prepayment

calculation. Additionally, the BLM representative questioned some of the minimum items required in the draft rule.

Decision Submittal of the prepayment calculation including the “minimum items of information” requirement will remain in the draft rule. We will work with BLM on their concerns with the minimum information.

Issue Effective date of the prepayment.

Discussion The rule requires the effective prepayment date to be at least 6 months from the application date. We discussed the need for this length of time - it will allow thorough MMS and State review of the application and include time for a company to supplement an incomplete application and/or modify an unacceptable prepayment. Industry had no problem with this length of time as long as the rule held MMS to a firm decision date.

Decision The 180 day effective date will remain in the proposed rule.

Issue Prepayment application processing fee.

Discussion There was a general discussion of the need for a processing fee for the prepayment application, although we have not yet determined the amount of that fee. Industry questioned whether a “one size fits all” processing fee is appropriate given that some prepayments will require more review than others. They suggested a tiered approach depending on the difficulty of the review may make more sense. The Solicitor noted that BLM determines the amount of a processing fee case-by-case using the same law (FLPMA) that requires us to charge a fee. There appeared to be little enthusiasm from either MMS or industry for a case-by-case approach to processing fees.

Decision MMS will examine the feasibility of a tiered approach or a case-by-case processing fee when we go through the steps used to determine the fee.

§204.103 What is the minimum prepayment amount?

Issue There was no disagreement that the minimum prepayment will be the discounted minimum royalty payment over the life of the lease. The issue in this section was what discount rate should we use to calculate this figure.

Discussion Don Sant suggested that the treasury bond rate corresponding to the same period as the prepayment would be appropriate. For example, if the prepayment covered 5 years, you would discount the minimum royalty using the 5 year treasury bond rate in effect when you submit the application. There seemed to be consensus on this item.

Decision The draft rule will reflect this consensus.

§204.104 What will MMS do when it receives your request to prepay royalties?

Issue Will MMS allow a company to modify their prepayment?

Discussion The rule was drafted such that MMS will either approve or reject a prepayment application and offer no opportunity for a company to increase their prepayment. All parties agreed that this was probably too restrictive, especially given the complications and potential unknowns of any prepayment calculation. Industry also wondered if they would be given a chance to demonstrate the correctness of their calculation if we believed it was too low. For example, they may have information unavailable to MMS or BLM that shows reserves to be significantly less than we calculated.

Decision We will change the draft rule to allow a company to modify their prepayment and/or demonstrate that our calculation is faulty.

Issue Is 30 days to supply missing information on an incomplete application sufficient?

Discussion Industry thought that a strict 30 day time frame to submit missing information may be too restrictive. They were concerned that if they missed the deadline by one day, we would reject their application and keep the processing fee.

Decision We will rewrite the draft to allow a company to request an extension beyond the 30 days with good cause.

Issue Will MMS be bound by any time limits to make their decision?

Discussion Industry was concerned that there was nothing in the draft rule that held MMS to any deadlines to complete the prepayment review and issue a decision. They further stated that any deadline should be far enough from the date the prepayment is due to allow companies to modify their accounting systems and prepare the prepayment. MMS agreed that this deadline is necessary.

Decision The draft rule will include language that holds MMS to make a decision on the prepayment at least 30 days before the effective date of the prepayment.

Issue Will MMS keep processing fee if application is not processed by due date?

Discussion MMS foresaw a situation where we received too many prepayment applications to process them all by the deadline added in the earlier decided issue. There was no provision handling for this situation in the draft rule.

Decision MMS will add language to allow for the return of the application and processing fee to the company if we cannot complete a timely review.

§204.105 What criteria will MMS use to preliminarily determine whether to approve or deny your request?

Discussion There were no outstanding issues related to this section of the draft rule. Everyone agreed that it is necessary for MMS to provide companies with the criteria we will use to evaluate the prepayment application. The draft rule will list our evaluation criteria and ask for comments on the appropriateness of those criteria.

§204.106 Who will decide whether to approve or deny your prepayment request?

Issue Should the rule be more specific on how we will obtain the State official responsible for approving prepayments?

Discussion All parties thought this section was too vague as to how MMS will find out who in a State is responsible for approving prepayment applications. The same issue also applies to the Accounting Relief rule.

Decision The Solicitor agreed to rewrite this section to require States to submit the name of the approving official within 30 days from the effective date of the rule.

§204.107 How will MMS and the State jointly determine whether to approve or deny your prepayment request?

Issue When will we send the prepayment application to the State?

Discussion We anticipated that most States will perform a cursory review of the application after we have decided whether to approve or reject the application. As such, this section of the rule only allowed the States 30 days to review the application, which would be sent to them after we completed our review. The State representatives indicated they would like to see the application as soon as possible and not wait for us to review it.

Decision We will rewrite this section so that MMS will send the application to the State as soon as we have determined that the application is complete.

§204.108 May a State decide in advance that it will not allow you to prepay your royalties under this subpart?

Issue Should there be a time limit for a State to decide it will not participate in this program?

Discussion There was some concern that this section did not require a State to decide within a certain amount of time that they would not allow prepayments. All parties agreed that the States should be bound by some time limit.

Decision We will require the States to notify MMS within 30 days from the date of the rule to opt out of the prepayment program.

Issue Can a State opt back in if they initially decided not to participate?

Discussion The rule did not allow a State to change their mind once they decided to disallow prepayments. All parties agreed that a State should be allowed to opt in to the prepayments even if they initially declined to participate.

Decision The Solicitor agreed to rewrite this section to allow States the opportunity to accept prepayments at a later date.

§204.109 How will MMS notify you of the decision to approve or deny your prepayment request?

Issue Similar to §204.104, this section contained no language telling a company when MMS would notify them of our decision.

Decision We will modify this section such that a company will be notified of our decision at least 30 days before the effective date of the prepayment.

Issue Should the rule specify any criteria for the denial of an application?

Discussion Industry was concerned that we could capriciously deny their application unless some denial criteria was in the rule. Although MMS understood this concern, we believe that listing our denial factors is unfeasible because this list would have to be comprehensive and unchanging. We further stated that Industry's concerns are unfounded because our denial will state our reasons for denial and allow Industry to appeal the decision.

Decision The draft rule will not contain a list of factors that we would potentially use to deny a prepayment application.

§204.110 What regulatory requirements must you meet if MMS and the State approve your prepayment?

There were no outstanding issues related to this section of the draft rule. However, when discussing this section, we noticed that it needed a minor organizational change - section (c) should be moved to a new section (a)(3). This draft rule will reflect this change.

§204.111 What are your future obligations after you prepay your royalties?

Issue The title of this section is misleading.

Decision We will rewrite the title of this section to something similar to “What current obligations are you no longer responsible for after you prepay your royalties?”

Issue Why include reports no longer required for Federal leases?

Discussion The rule stated that companies no longer had to submit transportation and processing allowance forms after they prepay. This statement is unnecessary because those forms are no longer required for Federal leases.

Decision We will remove those two forms from the draft rule.

Issue What are a company’s record-keeping requirements after they prepay?

Discussion There was considerable discussion on this issue. The discussion first focused on what sales records - i.e. run tickets, gas charts, sale contracts, could potentially apply to any record-keeping exclusion. This led to the realization that no one was sure if the FOGRMA record keeping requirements could be waived, and even if they could, MMS was not sure we wanted that. There was some belief among MMS that we could potentially use the actual sales from a prepaid lease to value production from other leases in future valuation scenarios. Industry was very adamant that we or any government entity (primarily IG) should not be able to examine their actual sales transaction after the prepayment because this inspection could lead to second-guessing and a potential demand for more money.

Decision No decision was reached on this issue. Resolution will require more research and discussion.

§204.112 Will you ever need to make additional royalty payments?

Issue What are appropriate conditions to trigger additional royalties under the “developments that deviate significantly” section of the law?

Discussion This issue received considerable discussion. The draft rule was written such that additional royalties are due only if production exceeds the volume used in the prepayment by a certain threshold. Everyone agree that the law intended for production to be an additional royalty factor. We next discussed whether other factors such as commodity price should require additional royalties. This option was strongly objected to by industry as unwarranted second-guessing. They did say that a sustained, dramatic change in market conditions may be a reasonable factor to require additional royalties but said that in the interest of fairness, we should repay royalties if the market took a downturn.

Decision An increase of production over a certain threshold will require additional royalties. We

will further examine whether the rule should contain a provision requiring additional royalties (and possibly a prepayment payback) if the market changes drastically.

Issue What is an appropriate production threshold?

Discussion The first issue discussed was what would be an appropriate percentage to require additional royalties. Percentages from 10 to 30 were mentioned with Industry favoring a larger percentage. They believe companies will be less inclined to prepay if the production threshold is too low. We next discussed including a volumetric trigger in addition to a percentage because it makes no sense to require additional royalties when the percent threshold equates to a very small volume. For example, if the prepaid volume was only 100 bbls and our threshold was 30%, then its not worth anyone's effort to collect additional royalties on only 30 bbls. Only when the volume and percent reach a certain limit would we ask for more royalties.

Decision The production threshold will be a combination of a percent and an absolute volume increase. We will establish both the percent and volume thresholds either through additional research and outreach or else provide a range in the draft rule and ask for comments.

Issue What are a company's options if they have to pay additional royalties but the property is no longer marginal?

Discussion This issue was actually raised in our discussion of § 204.114 but will be addressed in this portion of the rule. The issue is what happens when at the time the production threshold is exceeded, the property is no longer is marginal. Would we allow this property to be prepaid again or would we require monthly reporting? Some believed that once a property is marginal, we should always consider it marginal an a company can prepay their additional royalties. Others believed that if a property is no longer marginal when additional royalties are due, they should begin to report and pay monthly and not be given the option to prepay.

Decision No consensus was reached. We will conduct further research and ask for further input before making this decision.

§204.114 What happens if your property ceases to qualify as a marginal property under this subpart?

Issue Is this section necessary?

Discussion Many participants questioned the need for this section. The basic argument was why should we care what the production level was after the prepayment because we are protected by the requirement for additional royalties when production exceeds a certain threshold. There was consensus to delete this section.

Decision We will delete this section from the draft rule.

§204.115 May you prepay your royalties on a marginal property that benefits from other

Federal or State incentive programs?

Issue How will a prepayment be handled on a stripper well property?

Discussion There was some concern that we could lose royalties if we used the royalty rate in effect at the time of the prepayment and the stripper well program was discontinued. Industry was also concerned that because the royalty rate could potentially decrease over time, they may actually overpay their royalties. It was suggested that we add some wording that we will reevaluate the prepayment if the stripper program ends. This suggestion met with consensus. We could find no answer for Industry's concern about a potential overpayment because any future adjustment to a royalty rate is very speculative.

Decision A prepayment on a stripper property will be calculated using the royalty rate in effect at the time of the prepayment with the understanding that it will be reevaluated if BLM decides to end the stripper program.

Issue Unrelated to Current Sections of Draft Rule

Issue Who is liable for additional royalty if property is sold?

Discussion This issue is not addressed in the current draft rule. Industry was rightly concerned with the liability for future royalties if they sell the property. Would we go after the company who initially made the prepayment or the company who currently owns it?

Decision We will address the liability issue in the draft rule. However, further research is needed before we can make a decision.